

**DRAFT**

**PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**  
**Item #25 I.D.# 4925**  
**ENERGY DIVISION**  
**RESOLUTION E-3951**  
**September 22, 2005**

**R E S O L U T I O N**

**Resolution E-3951. Pacific Gas and Electric Company (PG&E) requests approval of its electric portfolio gas hedging plan. PG&E's request is approved.**

By Advice Letter (AL) 2685-E filed July 15, 2005.

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**SUMMARY**

**PG&E's proposed electric portfolio gas hedging plan is approved. The major elements of this resolution are summarized below.**

- 1) PG&E seeks Commission approval of a plan to specifically hedge the gas price risk associated with its electric portfolio. Prompt implementation of the plan is needed to help the utility manage its electric portfolio price risk exposure according to Commission adopted consumer risk tolerance policies. The hedging plan was filed as confidential protected material under Public Utilities (PU) Code section 583.
- 2) The hedging plan was submitted in response to the increase in the utility's gas related price risk resulting from the impending mid 2006 expiration of the 5.37 cents per kilowatt hour (kWh) fixed-price contract amendments for Qualifying Facility (QF) supplied electricity. If the fixed-price contract amendments are allowed to expire as currently expected, short-run avoided cost (SRAC) energy payments to QFs of all technology types will be based on spot border gas price indices, subject to monthly fluctuation.
- 3) PG&E has designed its hedging plan to augment and be consistent with its current Commission approved electric procurement plans and California Department of Water Resources (DWR) Gas Supply Plans. The hedging strategy is based upon the risk management methodology contained in PG&E's 2004 Short Term Procurement Plan, approved in Decision (D.) 03-12-062.

4) This resolution approves PG&E's hedging plan filed in AL 2685-E. Minor modifications to the hedging plan may be filed by advice letter subject to Energy Division review and approval, if appropriate.

## **BACKGROUND**

**PG&E is responsible for managing the price risk of its electric portfolio consistent with Commission consumer risk tolerance policies. The utility's risk management strategies are included in procurement plans approved by the Commission.**

Managing the price risk associated with the costs incurred procuring and generating electricity for its customer's needs is a critical utility function. PG&E and the state's other major electric Investor Owned Utilities (IOUs) conduct their risk management activities pursuant to Commission-adopted consumer risk tolerance guidelines and related requirements.<sup>1</sup> These guidelines establish reporting requirements and procedures to follow in the event that the utilities' level of price risk for their electric portfolios may exceed certain limits.<sup>2</sup> To meet this objective, the utilities are authorized to use a variety of financial hedging instruments such as natural gas futures and options. The utilities' risk management and electricity procurement strategies are contained in procurement plans approved by the Commission.

PG&E presented its current electric portfolio risk management strategy in its 2004 Short Term Procurement Plan (STPP), approved in Decision (D.) 03-12-062. "Operating targets" are used to guide the utility's risk management strategy. Operating targets refer to the value of its electric portfolio that the utility attempts to shield from price risk on a multi-year basis. The operating targets in the STPP were developed to address the price risk related to its electricity

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<sup>1</sup> Consumer risk tolerance is defined as the price that an average consumer would be willing to pay to reduce the risk of higher prices in the future. The Commission's current consumer risk tolerance level is one-cent per kWh over a rolling 12 month period. The utilities use a metric called "to expiration value at risk" (TeVAr) to measure the level of price risk that their electric portfolios are exposed to (generally referred to as an "open position"). The utilities notify their Procurement Review Groups (PRG) and Commission staff in the event that their price risk position is or projected to exceed certain limits in an effort to avert the possibility of a future electric rate increase (see D. 02-10-062, D.02-12-074 and D. 03-12-062).

<sup>2</sup> D.03-12-062 p. 16.

purchases and sales and were not designed for a specific sub-component of its electric portfolio price risk profile (e.g., the price risk resulting from SRAC pricing of QF supplied electricity). The risk management plan contained in the 2004 STPP is a companion to and essentially subsumed into PG&E's Long Term Procurement Plan (LTPP), adopted in D. 04-12-048.<sup>3</sup>

**The expiration of the five-year 5.37 cent/kWh fixed-price QF contract amendments in mid-2006 will significantly affect PG&E's electric portfolio.**

A significant factor impacting PG&E's electric portfolio and its gas open position is the expiration of a substantial number of fixed-price QF contract amendments representing a majority of the electricity supplied by QFs. These five-year 5.37 cent/kWh fixed price contracts were authorized after the 2000-2001 energy crisis in June 2001 and will expire in mid-2006.<sup>4</sup> Following expiration, SRAC energy payments will be based on spot border gas price indices subject to monthly fluctuation, as calculated using the modified Transition Formula adopted in D. 01-03-067.<sup>5</sup> As a result, this component of the utility's electric portfolio subject to gas price risk will increase substantially.

QF pricing issues are currently being considered jointly in Rulemaking (R.) 04-04-003 and R.04-04-025 "for the limited purpose of joint evidentiary hearings (EHs) on policy and pricing of Qualifying Facilities."<sup>6</sup> In addition to long-term policies for expiring QF contracts, the Commission will be considering:

"... all SRAC pricing issues, including, but not limited to: (1) whether or not the Commission's current SRAC energy price formula, including existing time-of-delivery and line loss factors, should be replaced, and if so, what changes should be made, and, (2) updating current as-available and as-delivered capacity prices" (R.04-04-025 Scoping Memo, January, 4, 2005, p.4-5).

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<sup>3</sup> See D.04-12-048, p. 155.

<sup>4</sup> D.01-06-015.

<sup>5</sup> See also PU Code section 390(b).

<sup>6</sup> ACR, February 18, 2005, [http://www.cpuc.ca.gov/word\\_pdf/RULINGS/43994.doc](http://www.cpuc.ca.gov/word_pdf/RULINGS/43994.doc)

Outcomes in these rulemakings may have a significant impact on PG&E's gas price risk exposure. Proposed decisions specifically addressing these issues are not expected until 2006.

**In AL 2685-E, PG&E presents a hedging plan responding to a significant increase in the proportion of its electric portfolio exposed to gas price risk. The increase in PG&E's gas open position is due to the possible expiration of fixed price QF contracts in mid-2006.**

In AL 2685-E, PG&E filed a strategy specifically designed to hedge the open position of its electric portfolio exposed to gas price volatility. The plan is intended to be responsive to the changing nature of PG&E's electric portfolio. This change is due to the anticipated shift to SRAC pricing for a considerable portion of QF supplied electricity beginning mid-2006. As a result, gas price risk will represent a significant proportion of the electric portfolio's overall price risk profile.

The impact of the QF pricing change and gas prices on PG&E's electric portfolio is discussed in the AL. Due to the anticipated expiration of the 5.37 fixed-price QF contract amendments, PG&E's gas open position will experience a substantial increase beginning in mid-2006. Accordingly, the utility says that a hedging plan is needed to reduce the exposure of its portfolio specifically related to gas price volatility and to manage TeVaR within PRG and Commission notification levels.<sup>7</sup>

To address this situation, PG&E proposes to implement a systematic hedging strategy based upon the operating target methodology adopted in its 2004 STPP. A prominent feature of the hedging plan is the use of operating targets designed specifically to close gas related open positions on a laddered, multi-year basis (referred to as a "ratable" hedging strategy) by using a diversified mix of hedging products. A primary benefit of this strategy is to reduce the probability that utility consumer electric rates will be significantly impacted by short-term gas price spikes. PG&E notes that the hedging plan will serve as a framework

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<sup>7</sup> While AL 2685-E is pending, PG&E is implementing an interim hedging strategy it discussed with its PRG earlier in 2005 (see AL 2685-E, p. 2).

for Commission compliance review in its quarterly and yearly Energy Resource Recovery Account filings.

PG&E requests that the hedging plan be approved quickly so that it may begin implementation of the plan well in advance of mid-2006.

### **NOTICE**

Notice of PG&E AL 2685-E was made by publication in the Commission's Daily Calendar. PG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

### **PROTESTS**

PG&E AL 2685-E was not protested.

### **DISCUSSION**

**PG&E's proposed electric portfolio gas hedging plan is approved. The utility may file modifications to the approved hedging plan via advice letter, subject to Energy Division review and approval.**

In our various procurement related decisions, we have adopted policies governing the price risk management practices of PG&E and the state's other major electric IOUs.<sup>8</sup> As important as it is to set the appropriate policies, it is equally critical to provide the utilities with the tools necessary to implement them. PG&E is requesting our consideration of such a tool in AL 2685-E.

Upon review, we find that PG&E has adequately demonstrated the significant impact that the fixed-price QF contract amendment expirations will have on its electric portfolio and, in particular, on its gas open position. Although the outcomes from our QF related rulemaking proceedings will likely have some bearing on this matter, the utility must respond to the situation as it currently

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<sup>8</sup> Under PU Code section 454.5 the Commission is required to (1) assess the price risk associated with each utility's portfolio; (2) ensure the utility has moderated its price risk; and (3) ensure the adopted procurement plan provides for just and reasonable rates, with an appropriate balancing of price stability and price level. (D. 03-12-062, pp. 16-7)

stands. Not taking steps now allowing PG&E to alleviate the QF related gas price risk may expose its electric customers to a price hike. While the costs of the proposed hedging plan are significant, it is appropriate to provide PG&E with the ability to effectively manage the gas price risk associated with its electric portfolio consistent with our policies and market conditions. We therefore approve PG&E AL 2685-E.

Furthermore, we note that price volatility in the natural gas market is most likely not a short-lived phenomena and that the ability to react effectively in such a turbulent and fast-moving market environment or other factors may cause PG&E to seek changes to its gas hedging strategy. While PG&E's plan provides for some degree of flexibility and specifies that it will consult with its PRG during its execution, the utility may find that modifications to the plan should be undertaken. Accordingly, PG&E is authorized to file minor modifications to the hedging plan approved in this resolution through an advice letter filing. We delegate authority for the review and, if appropriate, approval of any such advice letters to the Energy Division.<sup>9</sup> Prior to filing any such advice letters, the utility shall present its proposals to its PRG in an effort to mutually resolve any PRG concerns.<sup>10</sup>

Additionally, the utility is directed to file an advice letter the event that a decision in R. 04-04-003 and R.04-04-025 related to QF pricing will significantly impact the hedging plan approved in this resolution. In this advice letter, PG&E shall thoroughly describe the impact(s) of the decision and include any recommended courses of action.<sup>11</sup> Prior to filing any such advice letter, the utility shall present its proposals to its PRG in an effort to mutually resolve any PRG concerns.

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<sup>9</sup> The Energy Division may reject the advice letter if PG&E seeks modifications that the Energy Division considers are not minor or on other procedural grounds.

<sup>10</sup> At minimum, a gas hedging plan modification advice letter should include a detailed description of the proposed changes, supporting analysis, quantification of the proposal's costs and benefits and demonstrate how the proposal is consistent with the Commission's directives and PG&E's Commission approved procurement plans.

<sup>11</sup> Such an advice letter shall include the same type of information specified in footnote 10 if PG&E is requesting a change to its AL 2685-E gas hedging plan.

The advice letter procedures discussed above do not supersede or otherwise affect the risk management modification procedures adopted in D.03-12-062.<sup>12</sup> PG&E will be required to observe the procedural processes contained in D. 03-12-062 according to the circumstances described in that decision.

## **COMMENTS**

This is an uncontested matter in which the resolution grants the relief requested. Accordingly, pursuant to PU Code 311(g)(2), the otherwise applicable 30-day period for public review and comment is being waived.

## **FINDINGS**

1. PG&E filed AL 2685-E requesting approval of a hedging program primarily designed for the gas open position of its electric portfolio.
2. PG&E's proposed hedging program is designed to be consistent with the risk management strategies contained in its 2004 STPP and current LTPP approved by the Commission.
3. The majority of the fixed-priced contract amendments for QF supplied electricity authorized in D. 01-06-015 will begin to expire in mid-2006.
4. PG&E's gas open position will increase following expiration of 5.37 cents per kWh fixed-price QF contract amendments in mid 2006.
5. PG&E is required to conduct its risk management practices in accordance with the Commission's consumer risk tolerance policies and related requirements and should have the ability to do so.
6. It is reasonable for proposed modifications to the plan approved in AL 2685-E to be filed by an advice letter subject to Energy Division review and approval, if appropriate.
7. It is reasonable for PG&E to file an advice letter describing the significant impacts on the plan approved in AL 2685-E resulting from a decision in R.04-04-025 and R. 04-04-003.

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<sup>12</sup> D.03-12-062, p. 16.

**THEREFORE IT IS ORDERED THAT:**

1. PG&E AL 2685-E is approved and may be implemented upon the effective date of this resolution.
2. PG&E may file modifications to the hedging plan approved in this resolution through an advice letter, subject to the procedures described herein.
3. PG&E is directed to file an advice letter describing the significant impacts on the plan approved in AL 2685-E resulting from a decision in R. 04-04-025 and R.04-04-003, subject to the procedures described herein.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on September 22, 2005; the following Commissioners voting favorably thereon:

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STEVE LARSON  
Executive Director